Gulf Cooperation Council

How Can Growth-Friendlier Expenditure-Based Fiscal Adjustment be Achieved in the GCC?

Prepared by Staff of the International Monetary Fund

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

CONTENTS

EXECUTIVE SUMMARY[1]

After years of rapid growth in expenditure, GCC governments have started to implement significant fiscal consolidation measures, but more needs to be done. Rapid population growth and booming oil revenues led to large increases in government spending in the GCC in the decade to 2014, which now stands high by international standards. This expenditure is dominated by compensation of employees and other current spending which are large in percent of GDP compared to Emerging Market (EM) countries and other oil exporters. This keeps overall spending above levels consistent with long-term fiscal sustainability and intergenerational equity.

The international experience with large fiscal adjustments provides some key lessons for GCC countries. This experience suggests that growth outcomes improve when fiscal adjustments are sustained as part of credible multi-year fiscal plans, rely on expenditure more than revenue adjustment, and lead to improvements in expenditure composition (away from current outlays to more productive spending) and the structure of revenue (away from direct to indirect taxation). Successful fiscal adjustments also tend to be part of wider structural reforms that support growth.

Large fiscal adjustments are nothing new in the GCC countries. In the past, the size and duration of these adjustments have depended on the magnitude and persistence of the oil revenue shock. Past fiscal adjustments in the region have relied primarily on expenditure cuts as non-oil revenues were constrained by the underdeveloped tax system and narrow tax base. Fiscal consolidation episodes were associated with slower economic growth.

The challenge now facing the GCC countries is to design and implement further fiscal consolidation in a way that best supports growth and jobs. Specifically:

- ***Social transfers should be reformed and subsidies reduced*** to ensure government spending is better directed to those most in need. The subsidy reform should be gradual and accompanied with targeted compensation to lower-income households.
- ***Public investment should be streamlined***. Governments can improve investment efficiency by reviewing project appraisal, selection, and evaluation processes to ensure they are sufficiently robust and focused on improving access to essential infrastructure and competitiveness of the private sector.
- **Reforms are needed to public sector employment and compensation policies.** These would help reduce the wage bill and help address rigidities in the labor market to incentivize private sector employment of nationals.
- ***Spending efficiency in the education and health sectors*** **should be improved.** Gains from improvements in efficiency in these sectors could be significant.
- ***Strong medium-term fiscal frameworks should be put in place.*** Priority should be given to strengthening the annual budget process and introducing a medium-term fiscal framework to underpin and sustain the fiscal adjustment.

[1] Prepared by Ali Alreshan, Sohaib Shahid, Gazi Shbaikat (lead), and Vahram Stepanyan, under the supervision of Padamja Khandelwal. Research and editorial support was provided by Tucker Stone and Diana Kargbo-Sical.

A. Introduction

1. For most of the decade to 2014, rising oil prices fueled a large expansion of government expenditure in the GCC. Rising public expenditure supported strong growth and helped create jobs for a growing labor force. This, however, increased fiscal risks and vulnerabilities to adverse oil price shocks. The underlying fiscal position, as measured by the non-oil primary balance as a share of non-oil GDP, deteriorated sharply and the fiscal break-even oil price (the price that would balance the budget) increased on average for the GCC from $32 a barrel in 2005 to $63 a barrel in 2014.[2] With the sharp and abrupt decline in oil prices since late 2014, these risks have materialized as the region lost annual fiscal oil revenue of about $240 billion between 2014 and 2015. Fiscal deficits have emerged in most GCC countries.

2. Recognizing the challenge posed by low oil prices, GCC governments have developed and started to implement fiscal consolidation plans. Sizeable fiscal consolidation since 2014 has helped improve the non-oil primary balance and contain the deterioration in the overall fiscal balance. The average fiscal break-even oil price has declined to $52 a barrel in 2016. Further consolidation is planned over the medium term. This is appropriate as a continuation of the fiscal deficits seen in recent years would cause fiscal reserves to decline and government debt to increase sharply. Further, more needs to be done to achieve intergenerational equity.

3. Going forward, the challenge facing the region is to implement and sustain further fiscal consolidation while mitigating the impact on growth and employment. The appropriate design of the reform strategy (size, pace, and composition) will vary with each country's circumstance and available fiscal space. A careful design will help avoid across the board expenditure cuts and ad hoc revenue measures and will support private sector led growth.

4. This paper focuses on expenditure reforms and complements previous work by the IMF on the policy response to the decline in oil price. In particular, this paper does not cover the non-oil revenue reforms that are ongoing in the region and that have been discussed in previous IMF papers.[3] The paper is organized as follows. Section B discusses the case for further consolidation in government expenditure and reviews the structure and drivers of expenditure in the GCC countries against international benchmarks. Section C reviews previous episodes of fiscal consolidation, in the GCC and other countries to draw lessons that can help guide ongoing adjustment. A proposed expenditure reform agenda is discussed in section D. The last section concludes with some policy recommendations.

[2] The analysis in this paper is based on budgetary expenditures. Due to data limitations, the analysis does not include extra-budgetary spending by governments or by non-financial public entities.

[3] See, for example, "Tax Policy Reforms in the GCC Countries: Now and How?", 2015, and "Diversifying Government Revenue in the GCC: Next Steps", 2016.

B. The Need for Expenditure Adjustment in the GCC

Despite a sizable adjustment over the past two years, government expenditure in the GCC remains high by international standards and well above levels consistent with long-term fiscal sustainability and intergenerational equity. The recommended further adjustment size and pace reflects country specific conditions and available fiscal space.

5. A broad range of measures are being implemented by the GCC countries to adjust to the oil price decline. Expenditure was reduced by close to 10 percent in 2015-16 spanning a broad range of spending categories; wage and employment freezes were implemented in most countries with cuts in allowance and benefits (Oman), capital spending was prioritized (significant cuts in Saudi Arabia), subsidies on fuel, water and electricity were reduced (ranging from full elimination of fuel subsidy in the UAE to significant price increases in other countries), and transfers and non-essential spending were cut (all countries). Saudi Arabia has established the Bureau of Spending Rationalization which has helped identify opportunities for savings in capital and operational expenditures of key line ministries (Housing, Health, and Education). Together with some improvements in non-oil revenue, notably in Saudi Arabia, these measures reduced the non-oil fiscal deficit by around 17 percentage points of non-oil GDP since 2014.[4]

6. Public spending in the GCC, however, remains high by international standards, while non-oil revenue remains low. Expenditure as a share of GDP stood at 41 percent of GDP in 2016, versus 32 percent in emerging markets and 26 percent for a group of oil-exporting countries.[5] It was high across all the GCC countries, especially in Kuwait and Oman (above 50 percent of GDP). Public spending was also exceptionally high in per capita terms and as a share of non-oil GDP—the ratio of expenditure to non-oil GDP averaged 58 percent in 2016, ranging from 37 percent in the UAE to 94 percent in Kuwait. Moreover, the high expenditure levels in the GCC are not supported by a stable revenue base. Non-oil revenue covers less than a quarter of total spending in the GCC while in other countries expenditure is usually financed by broad-based tax systems that help ensure sustainability of public spending (in other oil-exporting countries, non-oil revenue covers about 50 percent of expenditure (Figure 1)). Risks to sustainability of the level of spending are exacerbated by the high volatility of oil prices and associated revenue.

7. An international comparison of the composition of expenditure suggests that high expenditure is concentrated in some categories (Figure 2). The compensation of employees and other current spending are large in percent of GDP compared to EMs and other oil exporters. The share of other current spending — almost twice as large as in emerging markets and other oil exporters — reflects the large on-budget subsidies and transfers in some GCC countries, and may also include some social benefits not reported elsewhere.[6] The share of capital spending in the

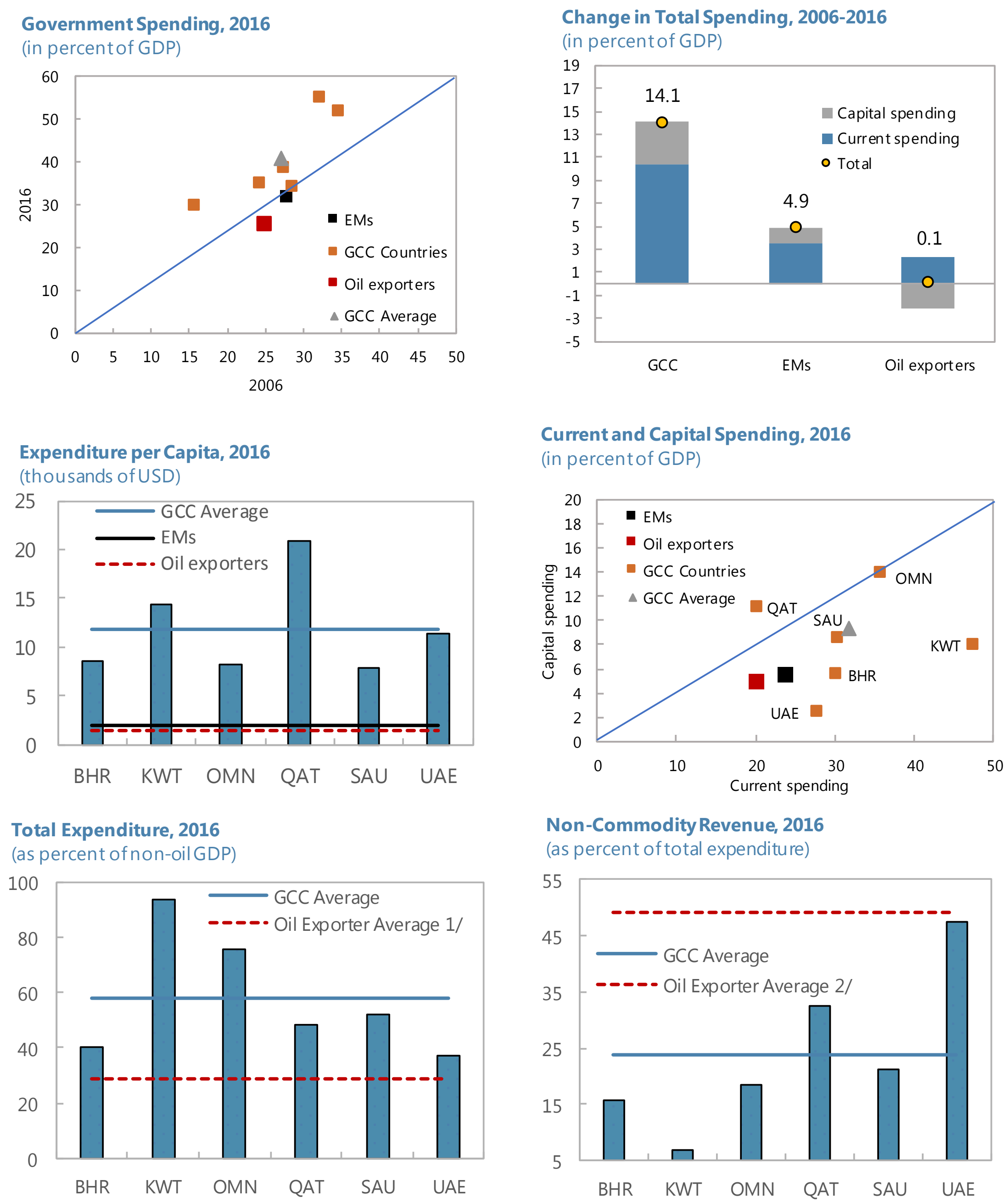
[4] Further progress to increase non-oil revenue was achieved in 2017 mostly through new/higher fees for government services in all the GCC countries and higher excise taxes in the UAE and Saudi Arabia.

[5] The group includes: Algeria, Angola, Iran, Kazakhstan, Mexico, Nigeria, and Russia.

[6] This is also why social benefits as a share of GDP are much lower than in other oil exporters and EMs (Figure 2).

GCC, close to 9 percent of GDP, is also higher than international benchmarks, while goods and services expenditure is comparable and interest expense is lower owing to low levels of government debt.

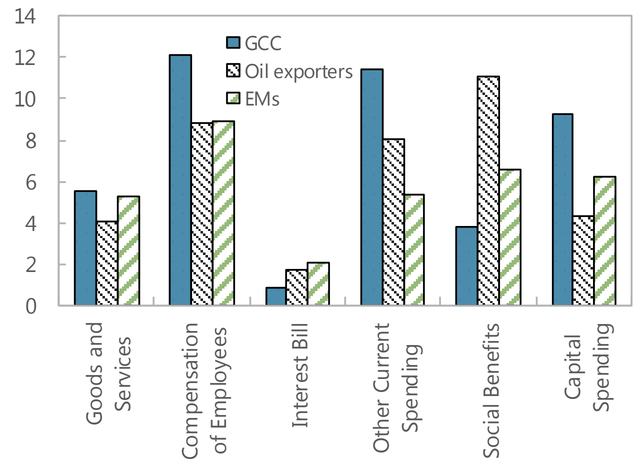
Figure 1. Government Spending in the GCC



Source: IMF FAD Expenditure Assessment Tool (EAT), IMF staff calculations.
1/ Does not include Mexico or Russia
2/ Does not include Mexico

8. Structural and institutional factors have shaped rising public expenditure in the GCC over time. These include:

Figure 2. Composition of Spending in the GCC
(2016; percent of GDP)



Source: OECD; Country authorities; and IMF staff calculations.

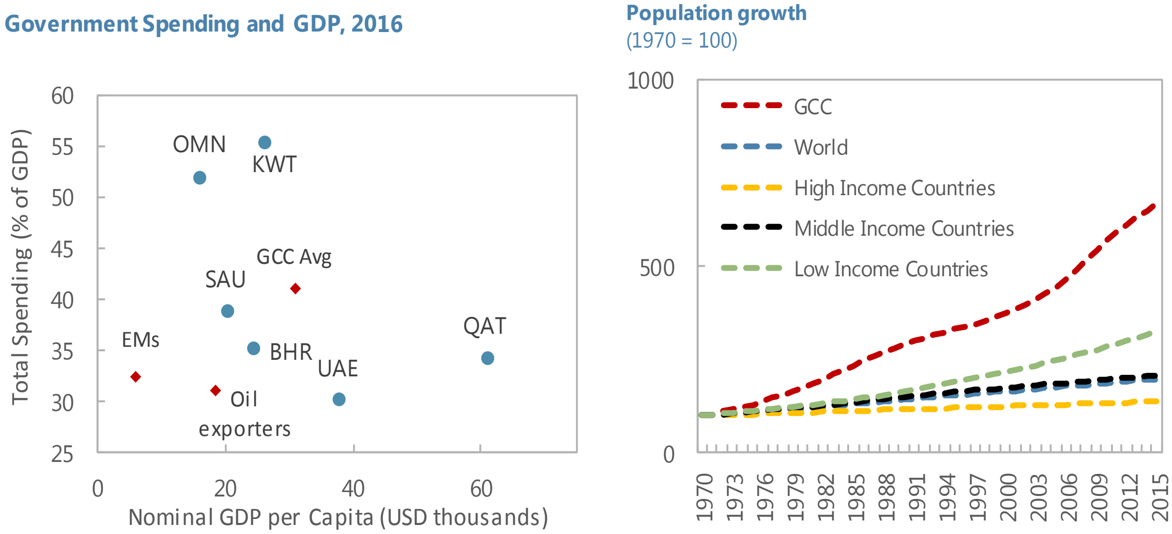
- **The close link between expenditure and oil revenue**. Rising oil prices have fueled a large expansion of government expenditure in the GCC since the early 2000s. The correlation between growth in government spending and growth in oil prices during 2000-2016 was 0.7.[7] While this is often the case in commodity-dependent countries, it reflects the lack of medium-term fiscal frameworks in the GCC which could help delink spending from oil price cycles.

- **Rising demand for and costs of government services.** Economic theory suggests that as income levels increase, both the demand for public goods and services ("Wagner's law") and the cost of providing them ("Baumol's cost disease") increase relative to other goods and services produced in the country. This leads to a rising proportion of government spending relative to total spending and hence a higher expenditure-to-GDP ratio. Expenditure reforms are needed to address this natural tendency for expenditure to grow over time.

- **Demographics and labor market structure**. The population of the GCC has increased more than six-fold since the 1970s owing to rapid population growth among nationals as well as expatriate workers (Figure 3). This is well above the population growth in other regions. Rapid population growth has increased pressure on infrastructure and demand for government services, leading to higher spending. Moreover, high population growth among nationals and the young population structure has meant a rising number of labor market entrants. With the public sector being the main employer of nationals, this has led to pressure on the government wage bill.

[7] The correlation between movements in oil prices and government spending was much lower in the 1990s.

Figure 3. Government Spending, GDP, and Population Growth



Source: IMF FAD Expenditure Assessment Tool (EAT); WEO; UN population division; IMF staff calculations.

- **Inefficiencies of public spending.** Albino-War et al. (2014) find that there is a substantial room to improve public investment efficiency in GCC countries. The analysis presented in the later sections of this paper also suggests inefficiencies in current spending. This means that achieving certain outcomes requires higher spending levels compared to other high productivity countries.

- **Large state ownership in the economy.** The state in the GCC holds large stakes in entities in a variety of sectors— banking, manufacturing, telecommunication, transportation, and utilities. Many of these entities remain dependent on government support through transfers.

- **Generous social welfare systems.** GCC governments provide citizens with a wide range of social programs that range from the traditional areas of free health and education and subsidized energy to the provision of generous untargeted support for housing and employment in the private sector (Table 1).[8] This level of comprehensive support goes above and beyond that provided in other countries and is not well targeted in the absence of means testing. It may also impact incentives among the labor force. Importantly, while large welfare programs are found in many regions including among advanced countries, the size of these programs is usually correlated with the level of taxation which ensures a stable financing source for the programs.

[8] Some of these benefits are captured in the category of other current spending or may be outside the central government budget.

Table 1. Housing, Social, Unemployment, and Other Benefits Provided to GCC Citizens[1/]

Benefits		Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
Housing	Land grant	√	√	√	√	√	√
	Soft loans	√	√	√	√	√	√
	Low-income housing	√	√	√	√	√	√
Social Security	Monthly allowances for low-income families, disabled, elderly, divorced, widowed	√	√	√	√	√	√
	Annual allowances					√	
Social Benefits	Marriage grant/ loan	√	√	√	√	√	√
	Renovation loan	√	√	√		√	
	Low-income families loan/grant	√				√	√
Health	Free health services, including treatment abroad	√	√	√	√	√	√
Education	Free primary to tertiary education	√	√	√	√	√	√
	Scholarship to study abroad	√	√	√	√	√	√
	Student stipend in public universities					√	
Employment & Unemployment	Wage subsidy	√	√			√	√
	Unemployment benefit	√	√	√	√	√	√
	Unemployment insurance	√				√	

Sources: Countries authorities and IMF staff

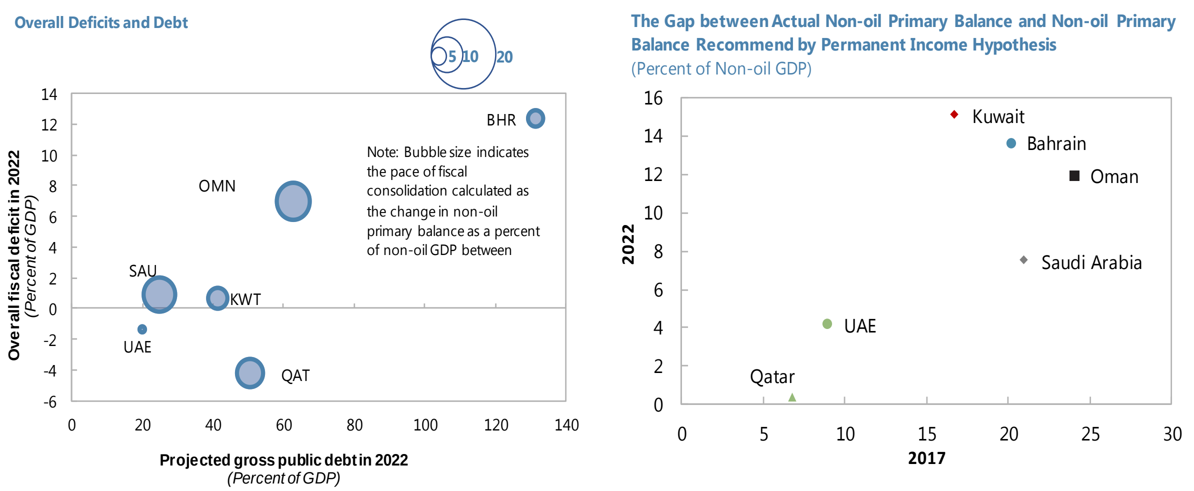
1/ This is not a complete list of all benefits provided to GCC citizens. Not all benefits are provided or financed by central government.

9. A continuation of current expenditure policies in the new lower oil price environment would increase risks to fiscal sustainability and make intergenerational equity harder to attain. The planned non-oil revenue reforms, especially the VAT, and continued spending restraint, projected by staff under baseline scenarios, will improve the underlying fiscal positions (indicated by the size of the bubble in Figure 4). However, the budget impact of these measures is projected to fall short of the level required to eliminate the fiscal deficits over the medium term, especially for Bahrain and Oman. Public debt will increase in all the GCC countries and financial buffers will be further depleted. None of the GCC countries—even countries with projected medium-term surpluses—are accumulating sufficient resources to ensure that future generations are not worse off once their hydrocarbon resources are exhausted— as indicated by the gap between actual non-oil primary balance and non-oil primary balance consistent with the Permanent Income Hypothesis (PIH) (Figure 4).

10. Staff estimates the appropriate size and pace of adjustment based on the available fiscal space and the appropriate fiscal anchor for each country. In this context, in addition to measures already underway and planned, staff recommend additional adjustment for Bahrain and Oman of over 10 and 6 percent of non-oil GDP, respectively, to put debt on a sustainable trajectory. In Bahrain, the adjustment should be frontloaded, while larger buffers in Oman allow a more gradual pace. In Saudi Arabia, where authorities have already undertaken significant measures and are planning more, and where buffers are larger, an additional 1.5 percent of non-oil GDP relative to the staff's baseline is recommended to balance the budget by 2022. Significantly more adjustment would be needed in these countries to restore intergenerational equity. For Kuwait, Qatar and the UAE where debt sustainability is not an issue given the much larger buffers, adjustments can be anchored by intergenerational equity (PIH gap) and phased in over longer horizons. On average, after factoring in the fiscal policy measures so far announced by the authorities, the non-oil fiscal deficit in the GCC countries is still projected to be about 10 percent of non-oil GDP larger than what is consistent with the PIH in 2022.

11. Expenditure adjustment in the GCC is also important to ensure external sustainability and competitiveness. Given the large share of public spending in aggregate demand and the high import content, government spending is a main driver of import demand in the GCC. Controlling spending, therefore, reduces pressures on the balance of payments. Moreover, expenditure policy, especially through controlling the growth of public wages, is crucial to protect competitiveness under a pegged exchange rate regime. Empirical evidence suggests that for less diversified oil-exporting countries, the external position is more closely linked to adjustments in government spending than to changes in the exchange rate (Behar and Fouejieu 2016).

Figure 4. GCC Fiscal Positions and Long-term Sustainability



Source: Country authorities and staff calculations

C. The Experience of Fiscal Adjustment and the Impact on Growth

While fiscal adjustments are key to ensuring macroeconomic stability and supporting long term growth if government debt is on an unsustainable or undesirable trajectory, country experience shows that the negative short-term impact of fiscal consolidation on growth was lower when adjustments were gradual, focused on expenditure, and supported by strong fiscal institutions and structural reforms. The GCC experience shows that large expenditure consolidations have occurred in the past and their impact on growth was larger when adjustment fell on capital expenditure.

International evidence

12. As experience in many countries has shown, fiscal adjustments can have a favorable long-term macroeconomic impact. Fiscal adjustments that address imbalances and reduce inflation and debt are critical to ensure fiscal sustainability and macroeconomic stability, a prerequisite for long-term growth. An IMF empirical study of a large group of advanced, emerging, and developing countries between 1975–2013 shows that adjustments were followed by growth acceleration in the long term and that countries which relied on both revenue and expenditure reforms achieved better results (IMF, 2015a).[9] Moreover, there is a well-documented supply side effect of fiscal adjustment on long-term growth if fiscal adjustment leads to higher efficiency and creates room from growth-enhancing spending.

13. There is, however, a direct adverse impact of fiscal consolidation on growth in the short term. The extent of this impact depends on a host of factors that relate to when and how adjustment is undertaken and the dynamic response of private consumption and investment to adjustment. Generally, when economic slack is large (during contractions), the cost of fiscal consolidation in terms of short-term output losses is larger. Empirical evidence, however, has shown that even in the short term, adjustment has a positive credibility-enhancing effect on private investment through lower risk premia and increased financing, helping mitigate the direct dampening impact of consolidation on aggregate demand. Other institutional and structural factors such as labor market flexibility and openness to trade also play a role in determining the impact of fiscal consolidation on growth.

14. The appropriate size and pace of adjustment in the GCC depends on country specific fiscal risks and vulnerabilities. While larger and faster adjustments are generally associated with lower growth, a strong positive impact of large adjustments on growth was found in a number of studies (Giavazzi and others (2000) and Giavazzi and Pagano (1990)). The Danish and Irish adjustment episodes of the 1980s provide examples of how sufficiently large and persistent adjustments alter expectations about future taxation, contributing to a consumption and

[9] Per capita growth in the long term is estimated at about ¾ percentage points higher following fiscal reforms in advanced counties and almost 2½ percentage points higher in developing countries (IMF, 2015a).

investment boom. Countries that undertook sizeable expenditure cuts were also able to reduce taxes (Chile and Ireland), contributing to more favorable output developments. [10]

15. Recent evidence has shown that the design of fiscal adjustment matters for growth. A review of empirical findings (see Alesina and others (2016), IMF (2013a), Hauptmeier and others (2006), Gupta and others (2005), and Tsibouris and others (2006)), shows that growth outcomes improved when adjustments: (i) were sustained and part of a credible multi-year fiscal plan (which helps positively impact private sector confidence); (ii) relied on expenditure more than revenue (although revenue-based adjustments were found to be more sustainable with greater benefits for growth in countries that start from a low tax burden and weak revenue administration);[11] and (iii) led to improvements in the structure of revenue (away from direct to indirect taxation) and expenditure composition (away from current outlays such as wages and subsidies to more productive spending).

16. Some growth-enhancing fiscal reforms may have adverse distributional consequences that can be mitigated by appropriately designing the reform strategy. Measures targeting higher indirect taxation, a reduction in subsidies and social transfers, and cuts in public wages and employment might have a detrimental impact on equality. Many countries, however, were able to implement such reforms without increasing inequality, for example, by using the proceeds of a regressive, yet growth-enhancing tax reform, to finance higher health and education spending. Reducing evasion and tax expenditures or loopholes that largely benefit the rich can simultaneously benefit growth and income equality (IMF, 2014). Malaysia's experience in the 1980s provides a successful example. A spending cut of about 10 percent of GDP was accompanied by measures that helped reduce inequality and poverty such as increasing the public provision of health and education services, in particular in rural areas, establishing a system of targeted transfers, and providing education and technical training to facilitate mobility from agriculture to higher-value added activities.

17. Supporting fiscal institutions and the implementation of structural reforms have a bearing on the durability of adjustment and growth outcomes. Country experience has shown that successful fiscal consolidation episodes were part of a comprehensive reform agenda that changed countries' economic policy regime significantly, often moving toward more private sector led growth, and strengthened fiscal institutions and accountability. Most countries have strengthened their public expenditure management and revenue administration and

---

[10] A review of major consolidation episodes between 1945–2012 shows that countries have on average adjusted by 1.6 percent of GDP annually for an average period of 3 years. The larger the initial deficit, level of public debt, and inflation, and the lower the initial growth, the larger the size of adjustment. Adjustment size also increases with the duration of the consolidation period when accompanied by an easing of monetary conditions and an improvement in credit conditions (Escolano and others, 2014). Other reviews of previous adjustment cases point to the tendency of countries to frontload adjustment— more than 50 percent of adjustments took place in first year (Tsibouris and others, 2006)

[11] Countries that increased the share of indirect taxation, matched by lower direct taxation, saw their growth accelerate (IMF 2015a), consistent with other findings in the literature that corporate income taxes have the most negative effect on growth, followed by labor income taxes, then consumption taxes and property taxes (see for example Arnold and others, 2011).

implemented key structural reforms in labor and product markets to enhance the business environment.[12] Specifically:

- Research on large fiscal adjustments points also to the importance of strong monitoring and accountability of fiscal targets, building-up public support through communication strategies and enhanced public debate, as well as planning for unexpected shocks as measures do not always yield the expected savings or are not fully implemented (Mauro and others 2013). These are important issues for the GCC where there is scope to strengthen fiscal institutions including multi-year fiscal planning and fiscal transparency.

- Complementary policies to incentivize increased employment of nationals in high-productivity private sector jobs, closing the gender and wage gaps, and implementing product market reforms—for instance improving the business environment, reducing trade barriers, institutional reforms to the legal system and property rights, and privatization— would also be critical to boost sustainable growth (see IMF 2016c for further discussion on structural reforms priorities in the GCC).

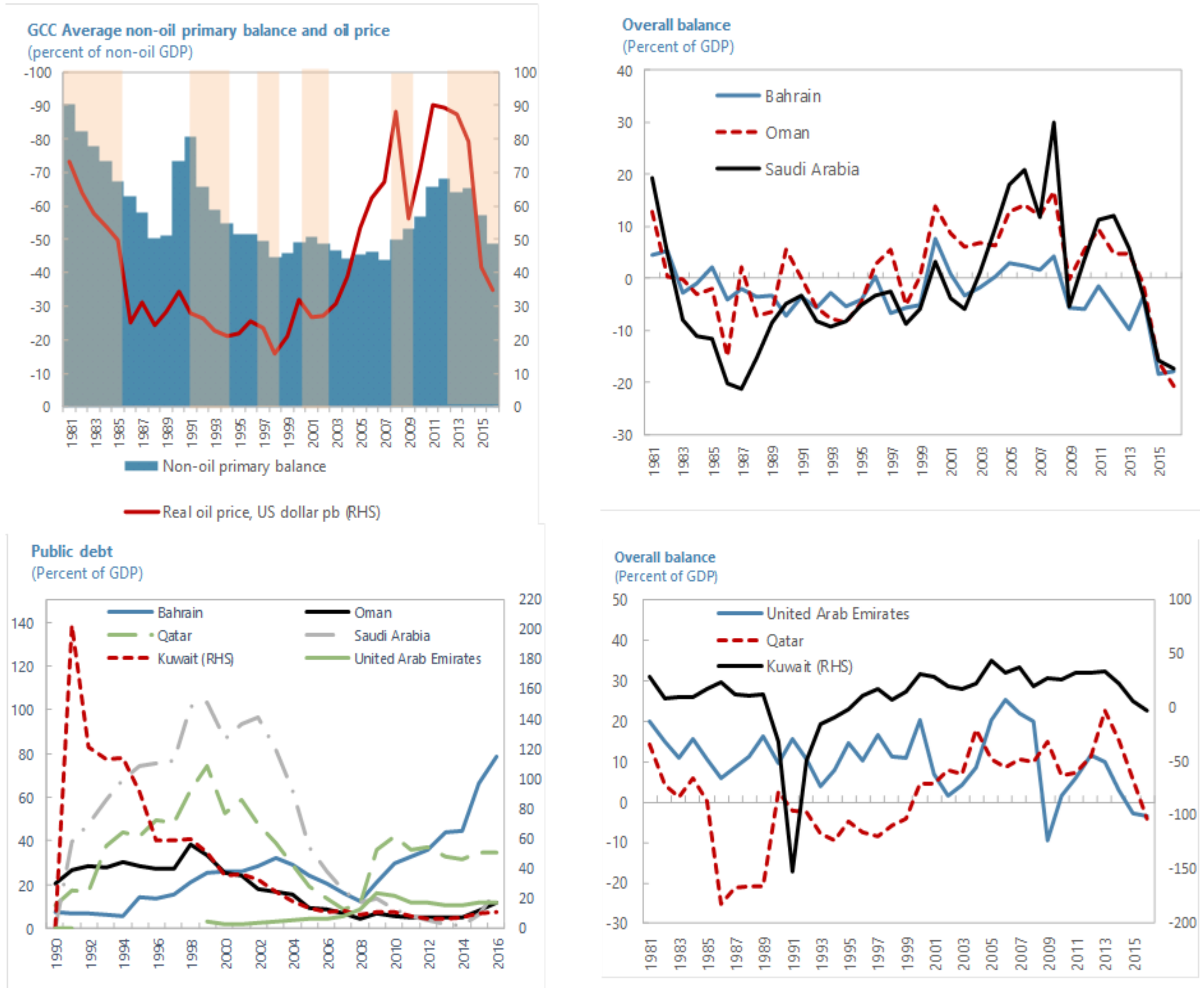
GCC experience with fiscal adjustments

18. Fiscal policies and outcomes in the GCC have been shaped by oil price cycles since the 1980s (Figure 5). These include: first, the sharp decline in oil prices in the early 1980s and the resulting emergence of large fiscal deficits; second, low oil prices throughout the 1990s with persistent deficits, debt accumulation, and financial asset drawdown; third, a prolonged oil price increase in the decade to mid-2014 that saw the GCC countries run large surpluses, lower debt, and build substantial financial buffers despite the acceleration of expenditure and; fourth, the current oil price decline in which the fiscal positions shifted back to large deficits, financed by asset drawdowns and issuance of debt.

19. Across GCC countries, however, fiscal outcomes have varied, reflecting the relative importance of oil revenue as well as the policy response. For instance, Bahrain has the lowest oil revenue as a share of GDP. Except for a few years after 2005, it has consistently run a fiscal deficit and its net debt has remained on an upward trend as a percent of GDP since the 1980s. In contrast, the UAE, where oil revenue is greater and diversification is more advanced, has maintained large surpluses including in the 1980s, and similarly for Kuwait except during the early 1990s (Figure 5). While the fiscal positions in most GCC countries were in surplus at the onset of the oil price decline, the net financial buffers as estimated by IMF staff vary considerably across countries, ranging from negative 50 percent of GDP in Bahrain to positive 460 percent of GDP in Kuwait.

[12] For instance, Chile accompanied fiscal adjustment in the 1970s and 1980s with PFM reforms (strengthening of budget control and cash management systems), introduction of MTFF and establishment of copper stabilization fund, establishment of large taxpayer units, and implementation of a large privatization program and labor market reforms. Ireland introduced in the mid-1990s multi-year budgeting, a Fiscal Responsibility Act, a budgetary rule, a debt rule, pension reforms, large privatization and PPPs programs, and labor market reforms.

Figure 5. GCC: Fiscal Indicators



Sources: Country authorities; and IMF staff calculations.

20. Large fiscal adjustments have occurred frequently in the past. Table 2 summarizes these adjustments— defined as episodes with a minimum cumulative improvement in the non-oil primary balance in nominal terms of 5 percent over two consecutive years.[13] Across the episodes, the median size of adjustment was about 7 percent annually (or about 6.5 percent of non-oil GDP annually).[14] The size and duration of the consolidation are related to the magnitude and persistence of the oil revenue shock— adjustments were largest and across all countries in the 1980s and large and in most countries in the current downturn (total adjustment was 36 percent

[13] Adjustments were identified as declines in the level of the nominal non-oil primary balance rather than as declines in the balance as share of non-oil GDP to avoid the impact of movement in the latter which may overstate or understate the size of adjustment. 14 adjustment cases were identified using this criterion; all 6 countries in the 1980s, Kuwait, Oman, and Saudi Arabia in 1990s, and all countries except Bahrain in the ongoing downturn since 2014. The analysis however, reports the change in both the nominal non-oil primary balance and the non-oil primary balance as a share of non-oil GDP during these adjustment cases.

[14] Oil revenue declined by more than 80 percent during the oil price downturn 1982–86, by 22 percent during 1991–94, 27 percent in 1998, by 30 percent in 2009, and by 70 percent during 2014–16.

of non-oil GDP in the 1980s and 17 percent so far since end-2014). In the less severe and shorter-lived declines in oil prices, only Kuwait, Oman and Saudi Arabia adjusted in the 1990s, while none of the countries adjusted during the oil price decline in 2008. The adjustments were also larger when the initial underlying fiscal position was weaker at the onset of the episode (see the level of the non-oil primary balance in the year preceding the oil price decline in Table 2).

Table 2. GCC: Fiscal Adjustment Episodes (1982–2016)

	Initial NOPB 2/	Consolidation size 3/			Duration	Contribution to NOPB change:	
Period 1/	% of GDP	% change in NOPB	% of non-oil GDP	% of oil revenue decline	# of years	Expenditure (%)	Revenue (%)
1982-88	-90.2	-30.5	-36.2	51.4	5.0	88.5	11.5
1991-98	-51.0	-23.1	-14.0	120.4 4/	3.0	89.9	10.1
2015-16	-64.3	-20.9	-17.4	30.8	2.0	89.3	10.7
Median		-23.1	-17.4	51.4	3.0	89.3	10.7

1/ Cases include: the 1980s (Bahrain between 83-87, Kuwait 82-87, Oman 85-88, Qatar 82-88, Saudi Arabia 81-86, and the UAE 81-88), the 1990s (Kuwait 91-97, Oman 94-96, and Saudi Arabia 92-94), and the current episode (all countries excluding Bahrain 2015-16).

2/ Level in years prior to adjustment (1981, 1991, and 2013).

3/ Cumulative improvement in NOPB in nominal term in at least two consecutive years with total not less than 5 percent (-) indicate improvement.

4/ Ratio above 100% indicates adjustment more than the decline in oil price.

Source: Country authorities and staff estimates

21. In general, the GCC countries have tended to adjust partially to oil price shocks (Table 2). The median size of adjustment represented about half of the decline in oil revenue across all episodes. Adjustments were also sustained beyond the oil price downturn; only a third of the adjustments in the 1980s were reversed in the 3 years after the end of the consolidation period. However, the consolidation in all the episodes was not adequate to stem the deterioration in the overall balance, which remained in large deficit through the 1990s and shifted back to surpluses only when oil prices rose sharply in the early 2000s.

22. Fiscal adjustments have relied primarily on expenditure cuts as the role of revenue has been constrained by the underdeveloped tax system and narrow tax base. On average, expenditure has accounted for about 90 percent of the total improvement in the NOPB in the adjustment periods.

23. A more detailed look suggests that the pattern and composition of expenditure adjustment has varied across countries and periods (Table 3). In most cases, expenditure was reduced in nominal terms. Expenditure cuts were large in the 1980s especially in Saudi Arabia, the UAE, and Qatar, all of which reduced spending by more than 30 percent and over a sustained period, while the smallest adjustment was in Bahrain. However, the median expenditure adjustment in the current episode (excluding Bahrain) is larger on an annual basis (about 7 percent in nominal terms and 11 percent of non-oil GDP annually). Expenditure consolidations in the 1990s and 2000s were smaller and short-lived except in Kuwait.[15] Adjustment fell largely on capital expenditure in the 1980s in most countries (on average, capital spending was more than halved between 1982–86 and contributed 60 percent of the total decline in expenditure).

[15] The 2000s adjustment includes some consolidation in 2001 and during financial crisis in 2008/9 but were not reported in table as they did not meet criteria of consolidation for two years and more than 5 percent.

In contrast, adjustment relied on current spending in recent episodes in Kuwait, Oman, and Qatar in all of which capital spending was increased in the current consolidation episode. On the other hand, Saudi Arabia has relied heavily on capital spending cuts in the current downturn (for all countries, the reliance on capital versus current spending cuts seems to reflect their relative share in total spending at the onset of the oil price shock; capital spending represented over 36 percent before the 1980's shock compared to 22 percent before the oil price decline in the current downturn). Within current spending, a breakdown is available since 1990 and shows that the GCC have tended to reduce spending on goods and services and other current spending and contained wage and salaries growth.

Table 3. GCC: Expenditure Consolidation During Adjustment Episodes, 1982–2016[1/]

	Size of adjustment		Duration	Contribution to Adjustment		Frontloading
	% change	in % of non-oil GDP	# of years	*Current(%)*	*Capital(%)*	*% of total in first year*
			1982-88			
Bahrain	-15.1	-2.5	4.0	NA	NA	2.1
Kuwait	-29.2	-37.4	5.0	8.8	91.2	5.9
Oman	-22.4	-30.9	3.0	40.0	60.0	18.7
Qatar	-33.2	-50.1	7.0	55.3	44.7	19.6
Saudi Arabia	-41.0	-34.2	5.0	25.3	74.7	0.0
United Arab Emirates	-32.0	-23.6	7.0	61.9	38.1	20.8
Median	***-30.6***	***-32.5***	***5.2***	***40.0***	***60.0***	***12.3***
			1991-98			
Bahrain	...	...	...	...	...	...
Kuwait 2/	-42.9	-148.0	6.0	100.6	-0.6	40.1
Oman	-4.2	-10.9	3.0	31.6	68.4	73.1
Qatar	...	...	...	...	...	...
Saudi Arabia	-18.3	-18.5	3.0	81.0	19.0	60.5
United Arab Emirates	...	...	...	...	...	...
Median	***-18.3***	***-18.5***	2.5	***81.0***	***19.0***	***32.9***
			2015-16			
Bahrain	...	...	...	...	...	...
Kuwait	-9.8	-26.3	2.0	123.9	-23.9	86.5
Oman	-14.9	-26.1	2.0	120.7	-20.7	54.5
Qatar	-21.9	-21.9	2.0	134.5	-34.5	3.4
Saudi Arabia	-19.0	-18.7	2.0	-27.2	127.2	65.4
United Arab Emirates	-13.9	-10.4	2.0	95.1	4.9	86.2
Median	***-14.9***	***-21.9***	***2.0***	***120.7***	***-20.7***	***65.4***

Source: country authorities and staff calculations

Note: "..." indicates no adjustment

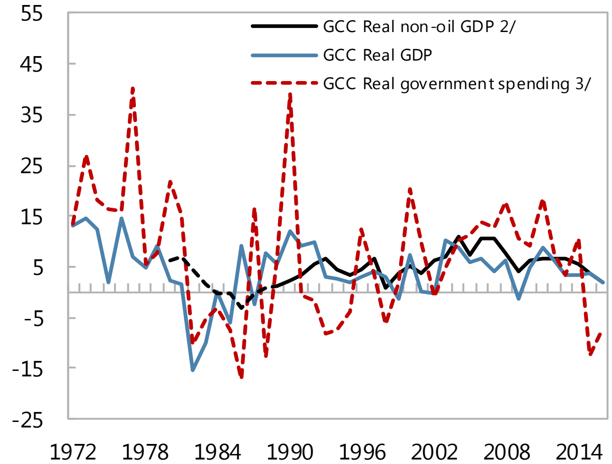
1/ Changes in expenditure during the consolidation episodes identified in Table 2. (-) indicate consolidation

2/ Consolidation in this period reflects Iraq invasion impact

24. The large fiscal consolidation episodes have been associated with slower economic growth. The adverse impact on non-oil GDP was more pronounced in the 1980s in Saudi Arabia, in part as adjustment was sharp and fell largely on capital expenditure. The accompanying decline in oil GDP also likely played a significant role as overall GDP declined in real purchasing power parity (PPP) terms by about 16 percent during 1982–86. In the 1990s and 2000s, fiscal adjustment did not take place in all countries and fell largely on current spending. This may have mitigated the impact on real non-oil GDP growth, which only slowed temporarily and remained above zero. During the current episode in which the bulk of the adjustment has fallen on current spending while capital spending has been protected in some countries, growth in the non-oil sector has slowed from about 6 percent in 2013–14 to 3.5 percent in 2015–16. However, the decline in growth is moderate considering the large size of fiscal adjustment, in line with empirical findings that the relationship between government spending and growth has weakened in the GCC since the 2008 financial crisis, likely reflecting higher import content and low spending efficiency during this period (Figure 6 and Box 1).

25. The foregoing discussion suggests there is scope to improve the design and composition of fiscal adjustment in the GCC to make it more growth friendly. In particular:

Figure 6. GCC: Real GDP and Government Spending
(y-o-y percent change) 1/



Sources: IMF World Economic Outlook; and IMF staff calculations.
1/ Growth rates weighted by PPP GDP.
2/ For 1980-89, data covers only Saudi Arabia.
3/ Deflated by domestic CPI.

- While GCC fiscal consolidation efforts since 2014 have focused on a mix of expenditure and revenue measures, the emphasis on revenue generation has been relatively modest and non-oil revenue lags far behind, even in comparison with other oil exporting countries. At the same time, despite cuts to expenditure, current and capital spending remain significantly higher than comparator countries, and can be reduced in a way to not only help ensure fiscal sustainability and restore intergenerational equity, but also to minimize the adverse impact on growth, support the structural reform agendas being pursued across the GCC, and strengthen social safety nets. Credible medium-term consolidation plans are also needed to help reduce macroeconomic uncertainty and boost confidence.[16]

- The slowing growth and employment in the GCC requires careful balancing of fiscal consolidation needs against growth considerations. Another consideration is that as the GCC countries tap both international and domestic markets to finance the deficits, this could eventually increase the cost of financing and crowd out private sector credit. For countries where fiscal deficits are relatively high, the benefits of implementing large, frontloaded adjustment could be sizable in terms of lowering macroeconomic uncertainty and crowding in private investment. Hence, front-loaded consolidation may have a relatively small adverse—or even a net positive—impact on growth in countries where fiscal sustainability gains are significant. On the other hand, countries which have fiscal space—such as Kuwait, Qatar, Saudi Arabia, and the UAE—can reduce the negative impact of consolidation on growth by adjusting gradually and setting out credible medium term plans to restore intergenerational equity and build policy credibility.

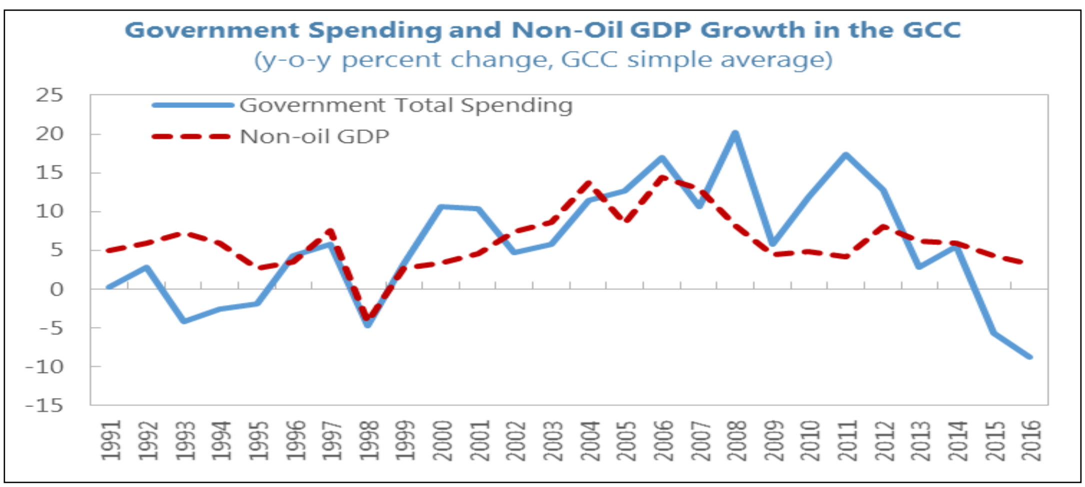
[16] Over the long term, anchoring the growth rate of expenditures in line with growth in non-oil revenue could also play a role in reducing the exposure of GCC countries' fiscal positions to oil price volatility. IMF (2016b) examines non-oil revenue measures that can help support fiscal adjustment in GCC countries.

Box 1. Declining Expenditure Multipliers in the GCC

The size of multipliers varies across countries and depends on various country-specific and global factors. Multipliers are lower when exchange rates are flexible, public debt levels are high, and public expenditure management and revenue administration are weak, while they are higher when labor markets are rigid. Multipliers can also be affected by trade openness, state of the business cycle, the degree of monetary accommodation to fiscal shocks, and the type and quality of adjustment (IMF 2014; Alesina et al 2016). Fiscal adjustment is likely to have a direct dampening effect on aggregate demand. However, this impact may be mitigated or even reversed in countries where fiscal sustainability concerns and macroeconomic uncertainty imply that fiscal consolidation leads to lower risk premia and crowding-in effect on financing to the private sector, and credibility-enhancing effects on private consumption and investment (Hemming et al, 2002; Alesina & Ardagna 2013).

Updated estimates suggest that fiscal multipliers in GCC countries have fallen in recent years. Previous estimates have found current and capital spending multipliers to be similar and quite low in the short-term (in the range of 0.2–0.4), which is unsurprising because both have high import content (final products and intermediate inputs as well as labor). In the long-term, the current spending multiplier is between 0.3–1.2, while the capital spending multiplier is higher, between 0.6–1.4. However, this relationship appears to have weakened in recent years. While the variations in government spending appear to be closely related to changes in non-oil GDP prior to the global financial crisis in 2008, the large increase in government spending since then and until the fall in oil prices seems to have had a much smaller impact on growth. Updated estimations indicate that fiscal multipliers have declined after 2008 (Fouejieu, Rodriguez & Shahid, 2017, forthcoming).

The decline in fiscal multipliers suggests that fiscal consolidation efforts in the GCC could be less costly in terms of growth than before. The decline in the multipliers points to a fall in the efficiency of fiscal spending or crowding out of private sector employment and investment. Alternatively, as GCC fiscal spending increased and surpluses shrank, the private sector may have increased overall savings, reducing the impact of spending on aggregate demand.



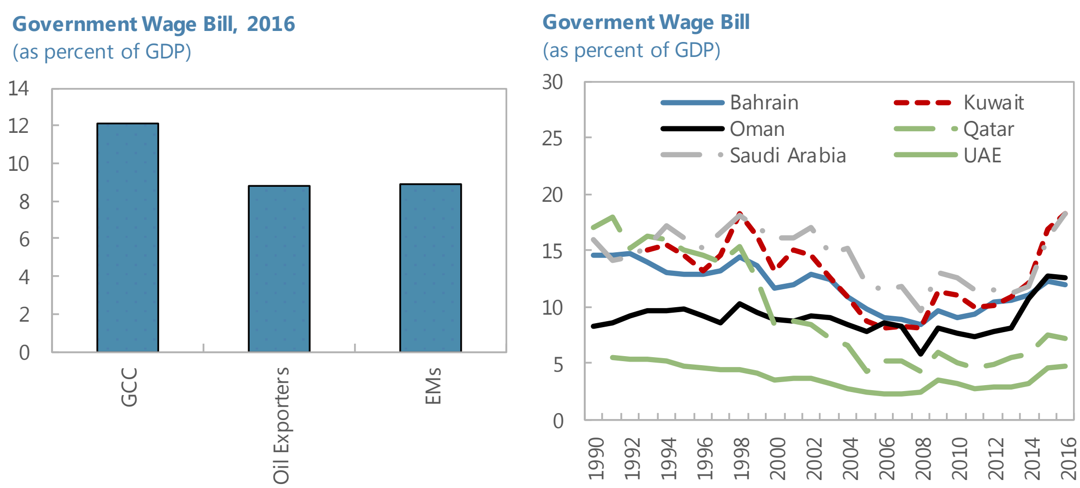
D. An Expenditure Reform Agenda for the GCC

The composition of the expenditure adjustment in GCC countries should be considered carefully. It should be designed and implemented so as to simultaneously increase the efficiency of public spending and enable a greater and more inclusive economic role for the private sector, especially small and medium enterprises. In this context, the following discussion lays out some considerations *that can inform areas where there is scope to unlock efficiency gains as well as areas where expenditure can be reoriented to support broad-based private sector led growth.*

Compensation and employment policies

26. GCC countries have some of the highest public sector wage bills in the world. Long standing policies in the GCC to ensure low unemployment among nationals through public employment and pressures to increase wages of nationals during oil price booms have increased the wage bill over the past decades. The wage bills have especially gone up since 2011, from an average of 7.6 percent of GDP to 12.2 percent of GDP in 2016 (about 60 percent nominal increase on average across the GCC), with the highest increases recorded in Oman, Kuwait, and Bahrain (Figure 7). Compared to other regions, the high wage bill in the GCC countries reflects both higher public sector employment as a percent of total national labor force as well as generous compensation.

Figure 7. Government Wage Bill in the GCC



Source: IMF FAD Expenditure Assessment Tool (EAT), IMF FAD Government Wage Bill and Employment Dataset

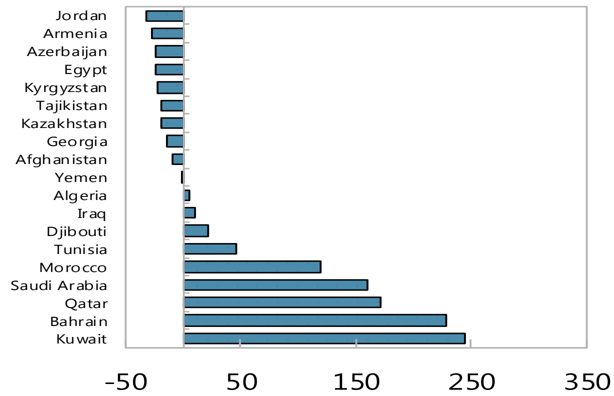
27. The wage bill is likely to increase further in the coming years in the absence of policy measures to control it. Pressure on the wage bill could increase in the coming years due to a young and growing national population[17] and rising labor force participation rates unless private sector job creation increases (IMF, 2013, 2014). Current compensation systems where wage increases are based primarily on the length of service will also contribute to pressures, unless reformed—for instance by implementing performance-based remuneration measures that incorporate effective incentives, within a specified cap on annual wage bill growth.

[17] According to World Development Indicators (World Bank-2016), the share of population between ages 0-24 is 33 percent, on average, among all the GCC countries. Saudi Arabia has the highest share of 40 percent of total population, while the UAE has the lowest share of 25 percent.

28. Reforms to public sector employment and compensation policies would help manage the wage bill and help address distortions in the labor market. The large public sector wage gap (Figure 8) provides a strong incentive for nationals, especially the low skilled, to prefer employment in the public sector, which absorbs the majority of employed nationals (ranging from 35 percent in Bahrain to close to 90 percent in Qatar (Figure 9)). The private sector mostly employs low-skilled expatriate workers at significantly lower wages. Such a duality discourages movement of (national) labor to the private sector and keeps the government wage bill high. Other benefits, such as fewer working hours, job security, and guaranteed pensions further incentivize nationals towards looking for jobs in the public sector. Reforms are needed to reduce the public-sector wage premium over time and would be critical to reallocate talent to the private sector and enable private sector led growth. Such reforms would also decrease the rent seeking associated with public employment and put a downward pressure on reservation wages. Additionally, education and vocational training reforms that equip the labor force with skills demanded in the market will help boost private sector employment.

Figure 8. Ratio of Public to Private Average Wages 1/

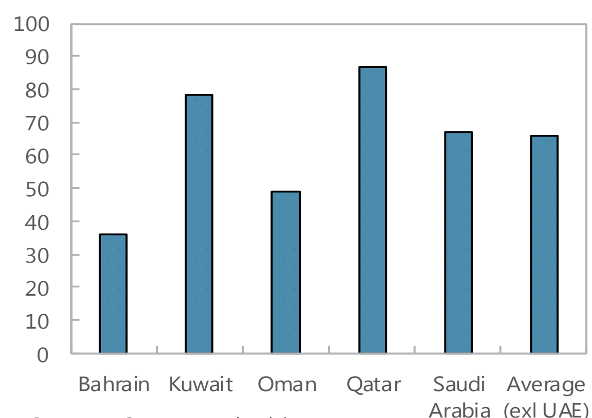
(Latest available, percent)



Sources: IMF 2017 (forthcoming), "Managing Public Wage Bills in the Middle East and Central Asia Region".
1/ Average public sector wage over average private sector wage, except for Tajikistan, Iraq, and Djibouti where the numbers represent wage premium estimates obtained after controlling for employee characteristics (IMF 2016).

Figure 9. GCC: Nationals' Public Sector Employment, 2015

(In percent of total employment of nationals)



Sources: Country authorities.

29. Across-the-board wage freezes or reductions in wages can address high and growing public wage bill, but may not be sustainable. Several GCC countries (Bahrain, Oman, Saudi Arabia) have tried to adjust their compensation outlays through temporary wage and employment freezes and reduction in some allowances. While these measures typically deliver almost immediate budgetary savings, their short-term gains may be offset by policy reversals.[18] To make these gains last, the measures need to be supported with structural and civil service

[18] For example, Saudi Arabia has restored government employee allowances that were reduced last year.

reforms that require careful planning and effective implementation *(*IMF 2017*a)*. GCC countries can also consolidate employment levels by limiting new hiring and relying on attrition-based employment reductions in overstaffed areas (IMF, 2016d). These reforms to public sector employment would need to be accompanied by measures to increase job opportunities in the private sector.

30. Reforms to the compensation schemes can lead to significant fiscal savings and economic benefits. These reforms — for example reducing and consolidating some allowances and bonuses into base pay — have not been implemented in the majority of GCC countries. While the introduction of such measures can bring about many benefits such as improved wage bill management and oversight, simplified wage bargaining, improved employer-worker matching, and strengthened transparency and fairness, they require adequate administrative capacity and time for planning. Furthermore, when implementing such reforms, it is important to ensure that they do not sidetrack from the objective of delivering fiscal savings and should lead to a reduction in the wage premium to facilitate employment in the private sector. A first step could be tightening eligibility and reducing the number and size of allowances over time in a phased manner to mitigate the social and financial impact of these measures.

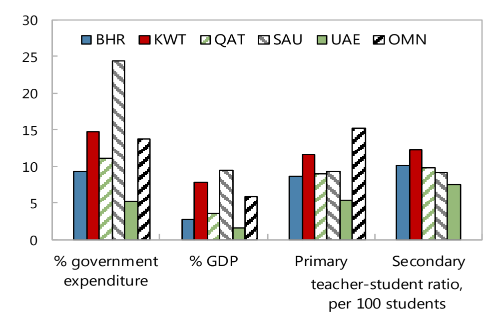
31. Public sector restructuring would help make a lasting adjustment in the wage bill. Restructuring should be preceded with a functional review of the public sector which will help design civil service reforms by effectively assessing the staffing levels needed to provide government services. Restructuring requires time, capacity, and political will, and the saving from which materializes only over the medium term. To avoid an increase in unemployment, any downsizing should be approached gradually and in tandem with efforts to increase employment of nationals in the private sector. This will be a difficult challenge given the slowing economy and will require effort to encourage greater participation in vocational training opportunities and updating education curricula to address any skills mismatch. Active labor market policies such as job search and matching services, wage subsidies, as have been implemented in many GCC countries, can play a key role.

32. Increasing spending efficiency in the education and health sectors could help achieve a sizable reduction in the wage bill without compromising outcomes. The health and education sectors have the largest share of public employees. There is considerable potential to achieve efficiency gains and redeploy public employment to the private sector, and at the same time reduce the dominant position of the state in these sectors. Programs to support better performance of teaching and non-teaching staff could help reduce the number of public employees in the education sector and reduce the teacher to student ratio which is high in the GCC compared to other countries (Box 2). In the health sector, there are apparent inefficiencies and a review of staff needs and compensation systems could lead to substantial saving (Box 3). Greater involvement of the private sector could help unlock efficiency gains by opening up sectors for competition, privatization programs, and the use of Public-Private Partnerships (PPPs)**.** In considering privatization and PPPs, the government should carefully assess the fiscal impact of these programs in the short and long term. The contingent liabilities and fiscal risks they may create need to be fully internalized into the decision-making process.

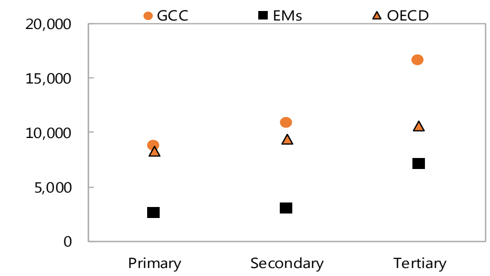
Box 2. Education Sector Reforms

The GCC countries have invested considerable resources in public education and have made significant progress in raising literacy and enrollment rates in recent decades. Education spending in the GCC countries per student is higher than levels in OECD and emerging market countries (EMs). However, education outcomes have been lagging and graduates often do not possess the skills needed for a 21st century global economy (Alfadala, 2015). Different indicators of education inputs and outputs— teacher-student ratios (TSR), education spending per student (in PPP$ terms), net school enrolment, and secondary-education overall PISA scores (where available)— suggest there is potential for enhancing education spending efficiency, although the extent of possible efficiency gains most likely varies between GCC countries.

Government Education Expenditure
(Latest value available)



Government Education Expenditure per Student
(PPP $ adjusted, latest value available)

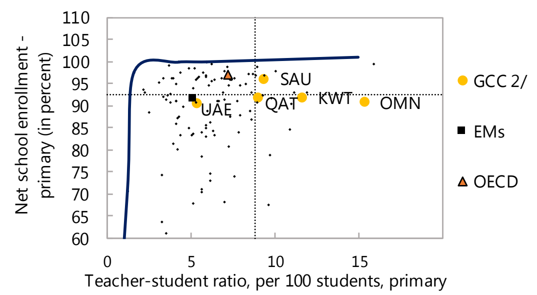


Sources: IMF FAD Expenditure Assessment Tool (EAT); World Bank; and country authorities.

There is scope to improve the allocation of education resources. In GCC countries, staff compensation represents a much larger share of the education recurrent expenditure compared to the OECD average[1] (OECD 2016). This suggests that financial resources allocated to quality-enhancing inputs such as teacher training and teaching and learning materials may not be sufficient.

High staff levels are likely to be the primary factor explaining the relatively high per-student cost in GCC countries. On average, the TSR (per 100 students) for GCC countries is around 9, while in OECD and in EM countries the ratio is around 7 and 6, respectively. While the TSR varies amongst the GCC countries, all countries fall well below the efficiency frontier (i.e. given the number of teachers per 100 students, net school enrollment should be higher to reach the frontier). In addition, a high nonteaching staff to teaching staff ratio (e.g. close to a third of staff in Oman are non-teaching staff) and high growth in total staff compensation and allowances explain the relatively high costs.

Teacher Ratios and School Enrollment
(Primary, latest value available)



Source: IMF FAD Expenditure Assessment Tool (EAT); and World Bank.
1/ Vertical dash lines and horizontal dash lines are the average of the GCC.
2/ There is no data on net school enrollment for Bahrain.

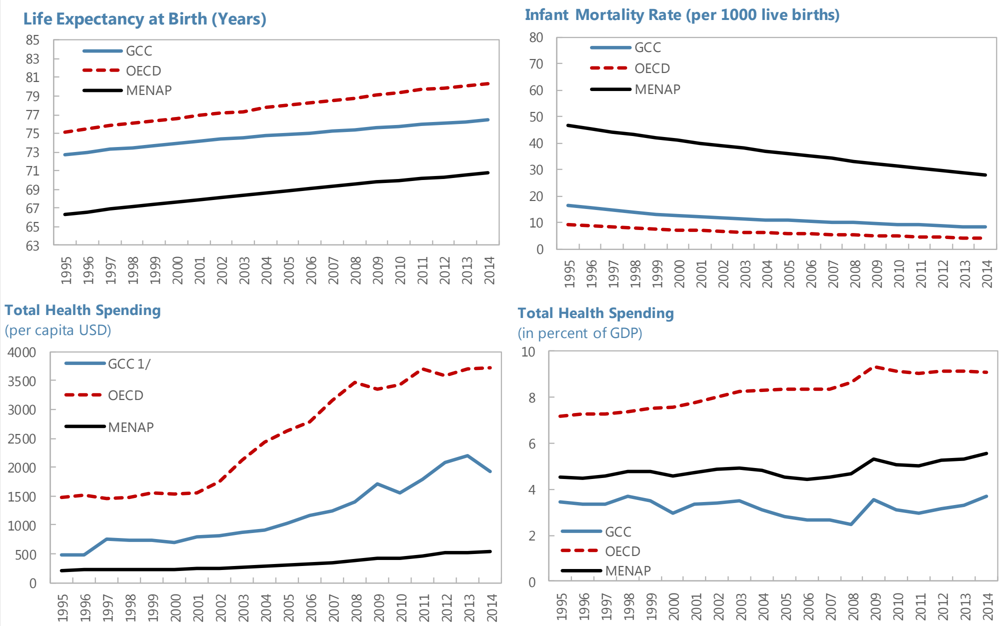
A reduction in the teacher and non-teaching staff headcount can be an effective measure to increase the efficiency of education spending. This could be achieved by redirecting the ensuing savings towards programs that improve teacher performance and quality of educational materials and other learning resources while maintaining the TSR close to the levels observed in OECD countries. Implementing a per-student financing formula such as in the Netherlands could ensure that wage costs remain in line with the number of students (IMF, 2014f).

[1] For example, in Oman, this share is close to 90 percent.

Box 3. Health Sector Reforms

GCC countries have achieved substantial improvements in health outcomes during recent decades. An increase has been recorded in life expectancy and infant mortality rates have fallen substantially. In terms of infant mortality, GCC countries have narrowed the gap with the OECD average substantially, but the life expectancy gap remains broadly unchanged.

Health Spending and Outcomes

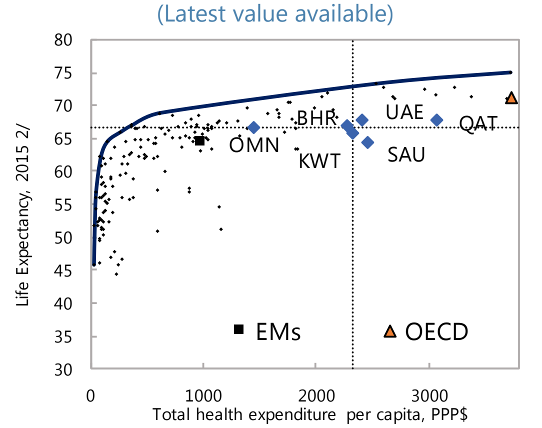


Sources: World Health Organization; World Bank, World Development Indicators; and IMF staff calculations
1/ GCC per capita spending is based on national population. GCC data does not include Qatar or UAE. It also does not include Kuwait for years 1995-96 and 2014.

Improvements in major health outcomes in GCC countries were accompanied by increased health spending. Per capita health spending has been on an upward trend and spending in percent of GDP has recently picked up in most GCC countries. Still, both indicators remain substantially below the OECD averages, possibly reflecting the young demographic structure and the large size of the expatriate population which usually do not benefit from some of the health services provided by the government.

GCC countries, however, appear to have non-negligible health spending inefficiencies. Their distance to frontier suggests scope for potential savings without compromising health outcomes. The average healthy life expectancy (HALE)[1] in the GCC region is close to 67 years, marginally above the average for the emerging markets and below that for the OECD countries. Total per capita health spending (in PPP adjusted terms) varies amongst the GCC countries, but all countries fall below the efficiency frontier (i.e. given the amount of health care spending, life expectancy should be higher to reach the frontier).

Health Efficiency Frontier
(Latest value available)



Source: IMF FAD Expenditure Assessment Tool (EAT); World Bank; and World Health Organization.

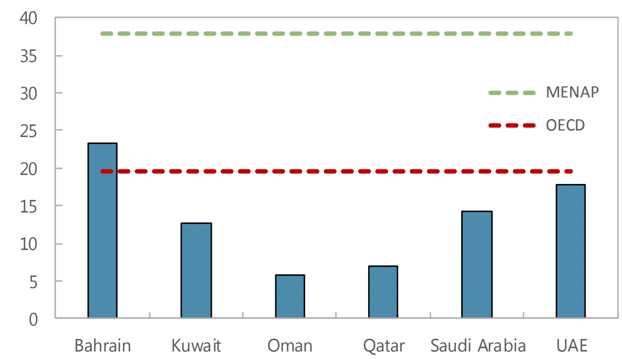
[1] Healthy life expectancy (HALE) is a measure of health expectancy that applies disability weights to health states to compute the equivalent number of years of life expected to be lived in full health.

Box 3. Health Sector Reforms (concluded)

Health systems in GCC countries are dominated by the public sector and provide strong financial protection for nationals. The out-of-pocket health spending accounts on average for 13 percent of total health spending. Except for Bahrain, this is below both emerging market and OECD averages as well as below the range of 15–20 percent that some studies have suggested as a threshold in terms of excessive financial burden on households (WHO 2010).

An aging population will increase demand for more costly health care services in the future. Leading health-related risk factors in GCC countries are linked primarily to unhealthy diets and physical inactivity (Aljefree et al., 2015), problems that will become more acute as the populations age and may create additional cost pressures. Introduction of excises on tobacco and carbonated/energy drinks will help to reduce consumption of harmful products.

Out-of-Pocket Health Expenditure, 2014
(Percent of total health spending)



Sources: World Bank, World Development Indicators; IMF staff calculations.

Energy subsidies, social benefits and transfers

33. **Energy subsidies in the GCC countries are high, accounting for almost a quarter of global subsidies.** In 2015, energy subsidies on fuel and electricity by the GCC were estimated to be at $94 billion out of $432 billion total world-wide (or about 6 percent of their GDP).[19] Accordingly, GCC countries also display the largest subsidies per capita. On average, subsidies in GCC countries are much larger than other oil exporters, as their price gaps are wider due to their typically very low level of domestic energy prices (IMF, 2015c). The total cost of the subsidy includes both explicit expenditure outlays in the budgets and implicit subsidies arising from forgone revenue and profits from energy companies (oil, gas, and electricity).

34. **Energy subsidies—whether explicit or implicit—tend to disproportionately benefit the well-off and crowd out spending with much broader and fairer benefits.** The cost of explicit energy subsidies in the GCC countries is usually in the form of transfers to utilities to compensate for the difference between production cost and the low domestic selling price. Even excluding classification issues, explicit subsidies in the GCC (excluding Saudi Arabia which is the only country that does not have explicit energy subsidies) accounted for about 3 percent of GDP in 2015 and were particularly high in Kuwait and Bahrain. There is considerable evidence that the wealthy benefit disproportionately. Further, subsidies detract resources from socially fairer expenditures including infrastructure spending, social spending (health and education), paying down of public debt, as well as pro-poor spending. As an example, Bahrain and Kuwait were

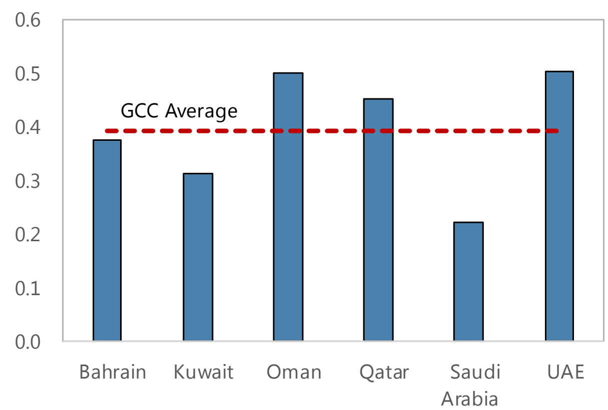
[19] This paper uses U.S. retail prices as benchmark prices, in line with earlier IMF work (see, for example, IMF, 2015, 2016, 2017).

spending more on subsidies than on capital spending in 2014 (IMF 2015c). Besides energy subsidies, the generous system of social benefits and transfers, which is not well targeted, is not only expensive, but also likely results in disproportionately small share of such spending reaching those most in need and may have an adverse impact on the incentives for nationals to work.

35. GCC countries have continued to make progress with addressing the critical issue of reforming domestic energy prices. Removal of subsidies in GCC countries can have a growth enhancing impact over the long-term (IMF, 2017 and IMF 2015c).[20] While energy price reforms are well advanced in some countries, the pace of reforms could be accelerated in others. Gasoline and diesel subsidies have been largely eliminated in the UAE and Oman as their prices were brought close to the international level.[21] While significant price increases have also taken place in Kuwait, Saudi Arabia, Qatar and Bahrain, fuel prices remain well below international levels (Figure 10). Electricity and water prices are being increased in Bahrain and Saudi Arabia under a multi-year plans, while Kuwait and Oman have increased electricity prices for businesses and other big consumers in the first half of 2017. Bahrain, Qatar, and Saudi Arabia increased water prices during 2015–16, while Kuwait increased the rates in 2017 for businesses and expatriate workers. Some countries plan to further rationalize water prices to cost recovery over the medium-term (e.g., Saudi Arabia).

Figure 10. GCC: Gasoline Prices

August 2017 or latest available, USD per liter 1/



Sources: Country authorities and IMF staff calculations.
1/ Prices are averages for 90 and 95 octane gasoline.

36. Key further steps include a formula-based approach or a complete liberalization of energy prices and introducing a means-testing approach to support a robust social safety net. Automatic price mechanisms help depoliticize the reform process, help avoid reform reversal, and facilitate the transition to a fully liberalized pricing system (IMF, 2017).[22] The costs and benefits of the reform should be clearly explained and communicated. To build public support, it is also important to design mitigating measures to protect the most vulnerable households from the impact of reforms to the extensive system of subsidies, social benefits and transfers. Such schemes should be income-tested and well targeted (as are being designed in Oman and Saudi Arabia). These reforms should be introduced in a gradual manner to make them more durable.

---

[20] IMF (2017), based on a sample of Arab countries, estimates that a removal of subsidies can provide a cumulative growth dividend of about 2 percentage points over six years for every percentage point of GDP in reduced subsidies if the resources are redirected into productive investment.

[21] The Emirate of Abu Dhabi started reforming electricity and water subsidies in 2014.

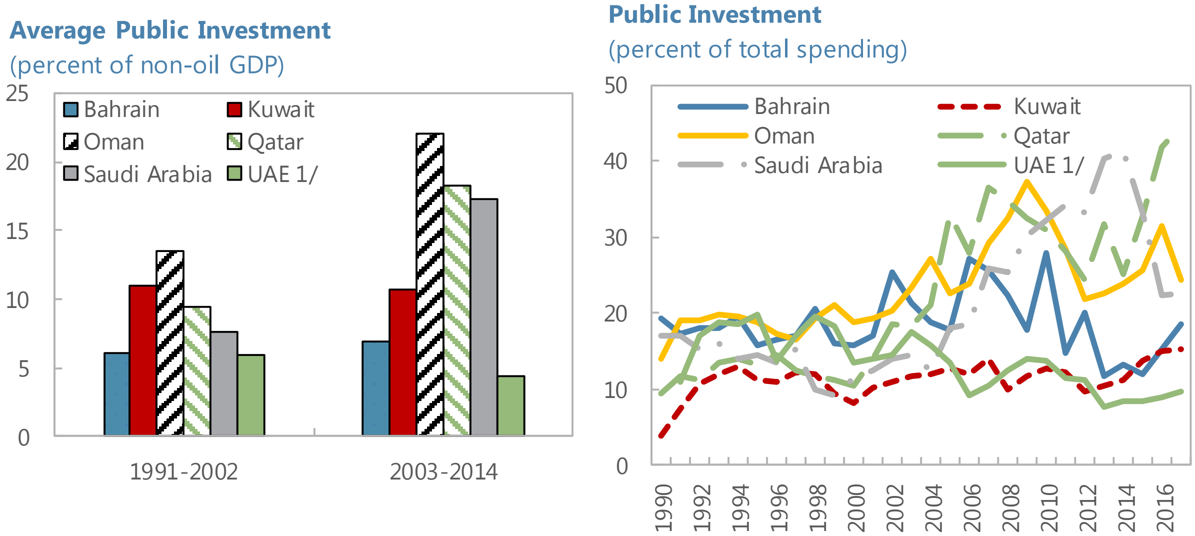
[22] An automatic price mechanism is already in place in Qatar.

Streamlining capital expenditure while safeguarding growth

37. Public investment can raise the economy's productive capacity and growth potential. However, not all public investment creates productive capital. In countries where public investment management frameworks are weak, public investment is unlikely to translate fully into productive capital and growth. For example, in a recent study, IMF (2015b) finds that the average country in the study sample loses about 30 percent of the value of its public investment to inefficiencies in the investment process. Moreover, every capital investment generates its own current spending in the short and long term.

38. Public investment in GCC countries has been positively correlated with oil prices. Average investment as a share of non-oil GDP was almost 4 percentage points lower during the lower oil price period (1991–2002) than during 2003–14 (Figure 11). In terms of its share, average public investment during the last decade has amounted to 22 percent of total government spending. Since end-2014, public investment as percent of non-oil GDP has declined from 15 percent to 13 percent, but remains high by international standards.

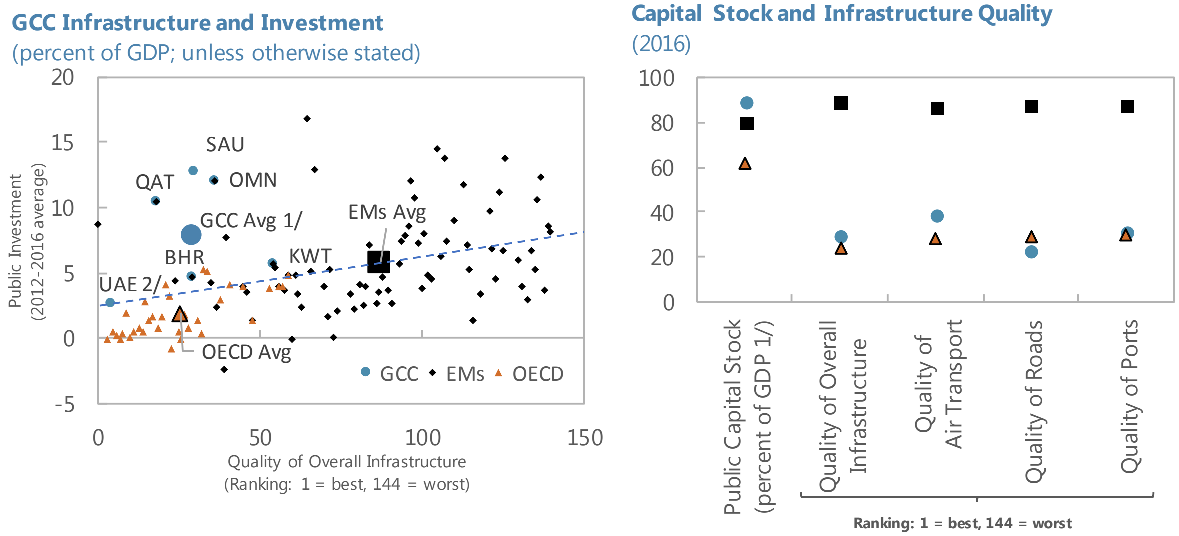
Figure 11. Public Investment



Sources: WEO; and IMF staff calculations.
1/ In UAE a large part of public investment is implemented by government related entities, data for which is not available.

39. GCC countries have built up a relatively large public capital stock and the quality of their infrastructure is on par with OECD countries. However, the high average ratio and scores mask notable variation amongst the GCC countries. In particular, capital stock in percent of GDP appears to be the highest in Oman, followed by UAE and Saudi Arabia. At the same time, in terms of the quality of overall infrastructure, UAE ranks first, followed by Qatar and Bahrain, suggesting that very high capital spending and stocks in some GCC countries may not necessarily have translated into high infrastructure outcomes (Figure 12).

Figure 12. Capital Stock and Infrastructure



Sources: IMF FAD Expenditure Assessment Tool (EAT), IMF Investment and Capital Stock Dataset; and World Economic Forum.
1/ GCC average does not include UAE
2/ In UAE a large part of public investment is implemented by government related entities, data for which is not available.

40. Streamlining public investment can be an important component of the fiscal adjustment in GCC countries. While protecting essential public investment is important, Albino-War et al. (2014) find that there is substantial room to improve public investment efficiency in MENA oil exporters, including in the GCC region. IMF (2016b) finds that high growth in the GCC has been the result of factor accumulation, both labor and capital, rather than improvements in productivity. The economic dividends from closing the "efficiency gap" could be substantial. Most efficient countries get twice the growth dividend from investment compared with the least efficient countries. Therefore, curtailing some public investment projects in the GCC could be appropriate and may have limited impact on domestic activity and long-term economic growth if their efficiency is low (Danforth et al., 2016).

41. GCC governments should review project appraisal, selection, and evaluation processes to ensure they are sufficiently robust. The aim for policymakers would be to examine whether the primary objectives of the project are being met in the most cost-effective way. The focus should be on: (i) project selection to be better aligned with development plans; (ii) more robust appraisal including consistently applied cost-benefit analysis and careful consideration of recurrent costs; and (iii) regular ex-post assessment of investment projects to inform future selection and implementation. Also, a periodic review of existing projects to check whether they are closely linked to, and efficiently meeting, developments goals could be helpful with a view to making additional savings in the capital expenditure budget.[23]

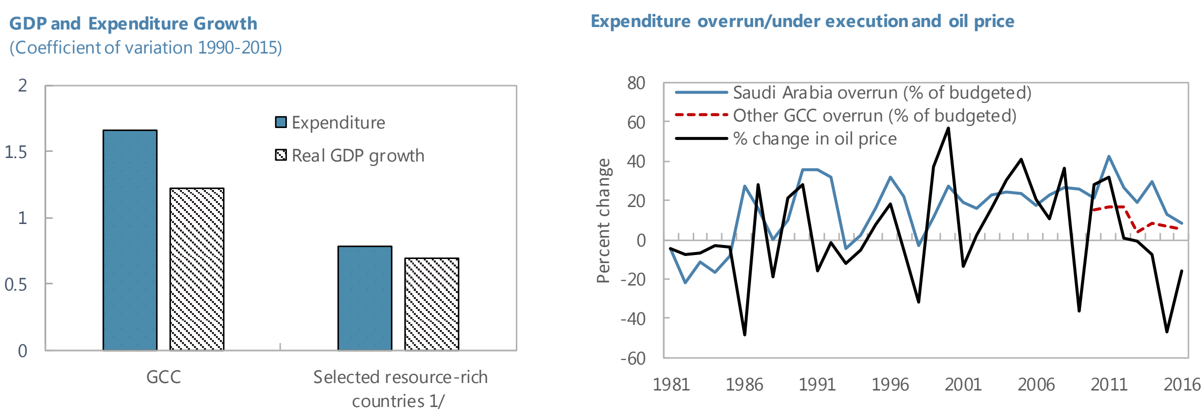
[23] The IMF's Fiscal Affairs Department has developed the Public Investment Management Assessment (PIMA) – a comprehensive framework to assess the quality of public investment management and identify the priorities for reforming it (IMF, 2015b) – that could be useful for governments in the GCC countries.

42. Governments can also use Public-Private Partnerships (PPPs) to procure investment projects that are produced more efficiently by the private sector. Well-designed PPPs can generate significant efficiency gains in the design, construction, and operation of assets and services and can offer greater value for money than traditional investments (IMF, 2016a). PPPs have been generally underutilized in GCC countries compared to other regions, but have recently picked up and there is growing interest in the region to increase the volume of infrastructure investment in partnership with the private sector. However, PPPs can also create significant fiscal risks, and reaping their full benefits will require strong legal and institutional frameworks to help limit and manage associated fiscal risks.

Strengthening the Expenditure Management Frameworks

43. Medium-term expenditure frameworks (MTEFs) could help the GCC have better control on expenditure and delink it from oil revenue volatility. MTEFs are part of a broader set of fiscal institutions that extend the horizon of fiscal planning and budgeting beyond the annual budget exercise which often leads to suboptimal fiscal outcomes. MTEFs integrate top-down macro-fiscal objectives, derived from a medium-term fiscal framework, with bottom-up sector programs and detailed multi-year expenditure plans. The reliance on MTEFs has increased in recent years including among resource-rich countries and their introduction has helped countries improve their fiscal performance. For the GCC, exposure to oil price volatility has led to high expenditure and growth volatility in the past (Figure 13). In this context, an MTEF is particularly important to delink spending decisions from short-term movements in oil prices and help address the challenge arising from the exhaustibility of the oil resource.

Figure 13. Expenditure and Oil Price



Sources: IMF, World Economic Outlook; and IMF staff calculations.
1/ Includes Chile, Indonesia, Malaysia, Mexico, Nigeria, and Norway and Singapore.

44. The GCC countries should build on the progress achieved in recent years to strengthen the fiscal policy frameworks. Saudi Arabia has announced fiscal objectives for the medium-term under the Fiscal Balance Program and Kuwait has approved three year rolling expenditure ceilings. The creation and strengthening of macro fiscal units (Kuwait, Oman, Qatar, Saudi Arabia, UAE) and public debt management offices (Bahrain, Kuwait, Oman, Saudi Arabia, UAE) are also key steps to upgrade capacity and support policy making.

45. Medium-term expenditure frameworks can be introduced gradually and should be properly sequenced with other fiscal reforms. Given existing budgetary weaknesses and capacity constraints, priority should be given to strengthening the annual budget process and expenditure management systems, starting multi-year planning with a simple medium term fiscal framework, and eventually moving to medium-term expenditure frameworks:

- A strong annual budget process is the starting point for effective medium-term budgeting. At present, the GCC annual budgets are a relatively poor guide to actual fiscal outcomes because spending outcomes are typically far above the initial estimates, although there has been some improvement since 2014 (Figure 13). Extending the budget horizon to two or three years only makes sense if there is a reliable point of departure—i.e., a firm annual budget. From a technical point of view, this means that the ministry of finance should include in the budget the best possible estimates. Good estimates require a sound understanding of how parameters drive annual expenditure, but also involve making repeated comparisons between the budget and the actual budget execution outturn—both in-year and soon after the end of the fiscal year. For GCC countries, there are three main areas for improvement in the budget process:

    - Strengthening the capacity to cost existing and new policies to ensure that the budget is an adequate reflection of expected costs.

    - Avoiding expenditure overruns by adherence to the adopted budget if oil prices turn out to be higher than budgeted.

    - Enhanced fiscal reporting (frequency, timeliness, and analysis) on in-year budget outturns. Furthermore, while the use of lower than actual/expected oil prices in budget preparations provides policymakers with a useful buffer, using more realistic oil price assumptions would enhance policy planning and budget transparency.

- Developing rolling MTFFs by setting the overall fiscal objectives for three to five years with quantitative targets for the main fiscal aggregates. The framework should also specify how these objectives will be achieved. The fiscal objectives should be consistent with the governments' policies (and the recently announced economic reform strategies and visions) given projected macroeconomic variables, oil prices, and demographics. This would set the stage for top-down budgeting.

- Establishing the link with the annual budget through a simple multi-year budgeting process by providing guidelines (envelopes) to line ministries to prepare medium-term spending plans. The spending ceilings for the following years can be treated as indicative targets until further reforms to build capacity and make the framework more binding take place.

- Developing comprehensive MTEFs. This final stage entails extensive organizational adaptability and technical capacity to implement MTEF not only at the ministry of finance but also at other government agencies who will be charged with expenditure strategy, costing programs, determining priorities within sectors, and measuring and evaluating programs. Their effective implementation also needs to be supported by sound public financial management practices.

46. The GCC countries would benefit from conducting comprehensive public expenditure reviews (PERs). PERs are a key diagnostic instrument used to evaluate the effectiveness of public finances and help countries develop more effective and transparent budget allocations. They typically analyze government expenditures over a period of years to assess their consistency with policy priorities, and what results were achieved. PERs may analyze government-wide expenditures or may focus on particular sectors such as healthcare, education, or infrastructure, and identify where there is room to increase efficiency or rationalize spending in areas that are more promising in terms of fiscal savings. The review could cover the central government operations as well as the extra-budgetary institutions and state-owned enterprises.

E. Conclusions and Policy Recommendations

47. The GCC countries need to consolidate their fiscal positions further to adjust to the new environment of lower oil prices. Despite the sizeable fiscal consolidation achieved so far, projections point to large medium term fiscal deficits and elevated levels of public debt in some GCC countries, implying a need for additional consolidation measures. The size and pace of adjustment should be dependent on country circumstances and available fiscal space, with due care paid to balancing fiscal sustainability requirements with short-term growth and employment considerations. Fiscal consolidation efforts may have adverse distributional consequences and should be mitigated by appropriately designing the reform strategy. Additionally, to make fiscal adjustment most effective, it should be coupled with growth-enhancing structural reforms.

48. Past adjustment experience in the GCC and other countries provides key lessons that can help guide future adjustments. While fiscal adjustment could have a favorable long-term impact on growth, consolidation in the short term may reduce aggregate demand and growth, underscoring the need for a careful design of the adjustment strategy and supporting structural reforms. Consolidation in other countries has been mostly expenditure-based which has generally tended to be less costly for growth than revenue measures. Mixing expenditure consolidation with revenue reforms would, nonetheless, produce better outcomes in countries with a low tax burden (as in the GCC), especially when revenue reforms focus on increasing indirect taxation. The GCC experience shows that past consolidations were largely based on expenditure cuts and that the negative impact on growth was more pronounced when the adjustments targeted cuts to capital spending. This all suggests that going forward additional fiscal consolidation should be based on a balance of revenue and expenditure measures. The adverse impact of fiscal adjustment on growth and jobs can be mitigated by: (i) focusing expenditure reforms on current outlays; (ii) adopting a sustained and gradual approach to adjustment; (iii) underpinning adjustment by strong medium term fiscal frameworks; and (iv) implementing broader structural reforms to support job creation and the dispersion of growth benefits across society.

49. A sustained expenditure adjustment requires a comprehensive review of the underlying factors that have shaped expenditure policy in the past. While a significant cut in spending was achieved over the past two years, expenditure in the GCC remains high by international standards and will likely remain on the rise in the future owing to economic, demographic, and labor market factors. Ensuring more sustained and efficiency-enhancing consolidation in the face of these expenditure pressures requires revisiting the traditional role of the government as a provider of jobs and services and implementing broader reforms to diversify the economy and address labor market distortions.

50. The expenditure reform agenda should focus on areas with potential fiscal and efficiency gains, notably the wage bill, subsidies, and capital spending.

- The government wage bill, which in the GCC is among the highest in the world, should be reduced to address fiscal vulnerabilities and labor market distortions, and to ensure that the benefits of government spending reach all society. It can be reduced in the first stage by tightening eligibility for allowances and reduction of the staff size by natural attrition. Restructuring based on well-designed civil service reforms needs to be approached gradually and in tandem with education and labor market reforms to increase employment and/or opportunities for nationals in the private sector.

- Supporting reforms and larger private sector involvement in the health and education sectors would improve outcomes in these sectors and reduce the size of public outlays.

- The GCC countries should also build on recent progress on energy price reforms by further closing the gap between international and domestic prices of fuel and electricity and move to automatic adjustment mechanisms accompanied by well-targeted compensation systems.

- A comprehensive review of the untargeted and costly transfers and benefits provided by the government to citizens (ranging from the traditional areas of free domestic health and education services to education stipend and medical treatment abroad, free and subsided housing, and untargeted wage subsidies) is warranted. Governments should seek to replace these programs with a better targeted social safety net using an efficient means-testing system. The reduction in social transfers should be well-designed, well-communicated, and sequenced to limit the impact on low-income households.

- Furthermore, streamlining capital spending based on robust public investment management frameworks will help mitigate the short-term impact of consolidation on growth.

51. Introducing multi-year expenditure frameworks can help control expenditure and delink it from oil revenue fluctuations. Priority should be given to strengthening the annual budget process and introducing a simple medium-term fiscal framework that lays out clear fiscal objectives for 3 to 5 years and follows a top-down sequencing to derive annual spending envelopes.

References

Albino-War, M., and others, 2014, "Making the Most of Public Investment in MENA and CCA Oil-Exporting Countries." IMF Staff Discussion Note 14/10, (Washington: International Monetary Fund).

Alesina, A. and S. Ardagna, 2013, "The Design of Fiscal Adjustments", NBER Chapters, in: Tax Policy and the Economy, Volume 27, pages 19-67 National Bureau of Economic Research, Inc.

———, and others, 2016. "Is it the "How" or the "When" that Matters in Fiscal Adjustments?," NBER Working Papers 22863, National Bureau of Economic Research, Inc.

Alfadala, A., 2015, "K-12 Reform in the Gulf Cooperation Council (GCC) Countries: Challenges and Policy Recommendations", The World Innovation Summit for Education.

Aljefree, N., and F. Ahmed, 2015, "Prevalence of Cardiovascular Disease and Associated Risk Factors among Adult Population in the Gulf Region: A Systematic Review", Advances in Public Health, Volume 2015, Article ID 235101.

Arnold, J., and others, 2011, "Tax Policy for Economic Recovery and Growth", The Economic Journal, Vol. 121.

Behar, A., and A. Fouejieu, 2016, "External Adjustment in Oil Exporters: The Role of Fiscal Policy and the Exchange Rate", Working Paper no. WP/16/107, (Washington: International Monetary Fund).

Danforth, J., A. Medas, and V. Salins, 2016, "How to adjust to a large fall in commodity prices," Fiscal Affairs Department, (Washington: International Monetary Fund).

Escolano, J., and others, 2014, "How Much is A Lot? Historical Evidence on the Size of Fiscal Adjustments," Working Paper no. WP/14/179, (Washington: International Monetary Fund).

Fouejieu, A., S. Rodriguez, and S. Shahid, 2017, "Fiscal Adjustment in the Gulf Countries: Less Costly than Previously Thought," Forthcoming, IMF Working Paper.

Giavazzi, F., and M. Pagano, 1990, "Can Severe Fiscal Contractions be Expansionary? Tales of Two Small European Countries," NBER Working Paper No. 3372 (Cambridge: National Bureau of Economic Research).

———, T. Jappelli, and M. Pagano, 2000, "Searching for Non-Linear Effects of Fiscal Policy: Evidence from Industrial and Developing Countries", European Economic Review, Vol. 44, No. 7, pp. 1259–89.

Gupta, S., 2005, "Fiscal policy, expenditure composition, and growth in low-income countries", Journal of International Money and Finance, Elsevier, vol. 24(3), pages 441-463.

Hauptmeier, S., M. Heipertz, and L. Schuknecht, 2006, "Expenditure Reform in Industrialized Countries: A Case Study Approach," ECB Working Paper, No. 634 (Brussels: European Central Bank).

Hemming, R., M. Kell, and S. Mahfouz, 2002, "The Effectiveness of Fiscal Policy in Stimulating Economic Activity—A review of the literature", IMF Working Paper WP/02/208, (Washington: International Monetary Fund).

International Monetary Fund (IMF), 2013a, "Taxing Times," Fiscal Monitor, October (Washington).

———, 2013b, "Reassessing the Role and Modalities of Fiscal Policy in Advanced Countries", Policy paper (Washington).

———, 2014, "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections," Technical Notes and Manuals, Fiscal Affairs Department (Washington).

———, 2015a, "Fiscal Policy and Long-term Growth", IMF Policy Paper, (Washington).

———, 2015b, "Making Public Investment More Efficient", IMF Policy Paper, (Washington).

———, 2015c, "Energy Price Reform in the GCC—What Can Be Learned from International Experience?" Annual GCC Meeting of Ministers of Finance and Central Bank Governors, (Washington).

———, 2015d, "Tax Policy Reforms in the GCC Countries–Now and How?" Annual GCC Meeting of Ministers of Finance and Central Bank Governors, (Washington).———, 2016a, "Investment and Growth in the Arab World—A Scoping Note," Staff Paper, (Washington).

———, 2016b, "Economic Prospects and Challenges for the GCC Countries", Annual GCC Meeting of Ministers of Finance and Central Bank Governors, (Washington).

———, 2016c, "More Bang for the Buck in the GCC: Structural Reform Priorities to Power Growth in a Low Oil Price Environment", Annual GCC Meeting of Ministers of Finance and Central Bank Governors, (Washington).

———, 2016d, "Diversifying Government Revenue in the GCC: Next Steps", Annual GCC Meeting of Ministers of Finance and Central Bank Governors, (Washington).

———, 2017a, "If Not Now, When? Energy Price Reform in Arab Countries", Annual Meeting of Arab Ministers of Finance, Rabat, April 18–19, (Washington).

———, 2017b, "Managing Public Wage Bills in the Middle East and Central Asia Region", (Washington (forthcoming)).

Tsibouris, G., and others, 2006, "Experience with large Fiscal Adjustments", IMF Occasional Paper No. 246, (Washington: International Monetary Fund).

World Health Organization (WHO), 2010, “Exploring the thresholds of health expenditure for protection against -financial risk,” 2010 World Health Report Background Paper, No 19.